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No. 84-1966 (2)

In the Supreme Court of the United States

OCTOBER TERM, 1985

CWT FARMS, INC., AND CWT INTERNATIONAL, INC., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
Acting Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

ERNEST J. BROWN
DAVID ENGLISH CARMACK
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

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QUESTION PRESENTED

Whether the courts below correctly determined that petitioner CWT International, Inc., failed to qualify as a domestic international sales corporation (DISC) for the tax years at issue.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A23) is reported at 755 F.2d 790. The opinions of the Tax Court are reported at 79 T.C. 86 and 79 T.C. 1054.

JURISDICTION

The judgment of the court of appeals (Pet. App. A24) was entered on March 19, 1985. The petition for a writ of certiorari was filed on June 14, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. CWT Farms, Inc. (Farms), a Georgia corporation, produces poultry products for sale in domestic and export markets. CWT International, Inc. (International) was created in 1972 as a wholly-owned subsidiary of Farms to

serve as a commission agent for Farms' export sales (Pet. App. A2). Farms established International in order to take advantage of the tax benefits provided for domestic international sales corporations (DISCs) by Sections 991 through 997 of the Internal Revenue Code.[1]

Congress enacted the DISC provisions to encourage exports of domestic products. S. Rep. 92-437, 92d Cong., 1st Sess. 6-7, 90 (1971). Although Congress conferred substantial tax benefits on DISCs, it established numerous and stringent requirements that a corporation must meet to qualify. The statutory requirement relevant here is the "95% qualified export assets test" set forth in Section 992(a)(1)(B). That Section provides that a corporation can qualify as a DISC only if "the adjusted basis of [its] qualified export assets * * * at the close of the taxable year equals or exceeds 95 percent of the sum of the adjusted basis of all [its] assets * * * at the close of the taxable year." This requirement is designed to ensure that the tax-deferral benefit of the DISC provisions is available only with respect to earnings that are reinvested in the export business.

"Qualified export assets" are defined to include "producer's loans" and certain "accounts receivable" held by a DISC (I.R.C. § 993(b)(3) and (5)). Generally speaking, a "producer's loan" is a species of loan made by a DISC to its parent or another related party. To qualify as a "producer's loan," an obligation must meet exhaustive statutory criteria (see I.R.C. § 993(d)). Among these are the requirements that "at the time of such loan it [be] designated as a producer's loan" and that it be "evidenced by a note * * * with a stated maturity date not more than 5 years from the date of the loan" (I.R.C. § 993(d)(1)(B) and (D)). In the case of

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[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax years in issue (the Code or I.R.C.).

"accounts receivable," the Treasury Regulations provide that accounts owed to a DISC by a related party, such as unpaid export commissions due from its parent, constitute "qualified export assets" only if they are "paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred." Treas. Reg. § 1.994-1(e)(3); see Treas. Reg. § 1.993-2(d)(2).

2. Upon audit of petitioners' 1975-1977 tax returns, the Commissioner determined that International in each year had failed the "95% qualified export assets test," and hence failed to qualify as a DISC, for two independent reasons. First, he determined that certain of International's assets, which had been listed on its books as "producer's loans," did not in fact constitute "producer's loans," since none of them on its face was "designated as a producer's loan" (I.R.C. § 993(d)(1)(D)), and since each took the form of a demand promissory note, rather than a note "with a stated maturity date not more than 5 years from the date of the loan" (I.R.C. § 993(d)(1)(B)). Secondly, the Commissioner determined that certain of International's accounts receivable, representing export commissions due from Farms, were not "qualified export assets" because Farms failed to pay them within 60 days after the close of International's September 30 fiscal year (Treas. Reg. § 1.994-1(e)(3)). See Pet. App. A2-A4. The Commissioner accordingly asserted deficiencies in tax against International and Farms. See Pet. App. A5-A6; 79 T.C. at 90, 92.

Petitioners sought redetermination of the deficiencies in the Tax Court. The Tax Court agreed with the Commissioner that International's demand notes did not constitute producer's loans because they failed to meet the statutory requirement of "a stated maturity date not more than 5 years from the date of the loan" (I.R.C. § 993(d)(1)(B)). The court rested its holding not only "on a literal interpretation of the statute," but also on the legislative history of the

DISC provisions, which furnished "additional indications that Congress did not intend that a demand note would satisfy" the statutory requirements (79 T.C. at 94). The court found it unnecessary to reach the Commissioner's other arguments as to why International's notes did not qualify as "producer's loans," *e.g.*, their failure to bear a legend identifying them as such (*id.* at 92). And because the Tax Court's holding that the demand notes were not "producer's loans" by itself caused International to fail the "95% qualified export assets test," the court found it unnecessary to determine whether International would fail to qualify as a DISC for other reasons, *e.g.*, because Farms had neglected to pay off International's export commissions receivable within 60 days of the close of the latter's tax year (*id.* at 92-93).

3. The Tax Court filed its findings of fact and opinion as outlined above on July 19, 1982 (Pet. App. A6; 79 T.C. 86, 93, 95). However, before the court entered its final decision—a decision that depended, under Tax Court Rule 155, on certain calculations by the parties concerning the precise amount of petitioners' tax deficiencies—petitioners filed a timely motion for reconsideration of the opinion. Petitioners stated their intention to take advantage of the provisions of Section 992(c) of the Code, which permits a corporation under specified circumstances to qualify as a DISC, retroactively as it were, by making a purging distribution to its shareholders, generally called a "deficiency distribution," in an amount equal to the value of its assets that are not "qualified export assets" (I.R.C. § 992(c)(1)(B)). In order to determine the amount (besides the amount of the demand notes) that would have to be thus distributed, petitioners requested that the Tax Court decide whether the commissions receivable owed to International by Farms were "qualified export assets." See 79 T.C. at 1055-1056.

The Tax Court granted petitioners' motion for reconsideration, concluding that International's "expressed * * * intention to make a deficiency distribution" to Farms presented "unusual circumstances" justifying such discretionary relief (79 T.C. at 1057, 1059). However, the court emphasized that, if petitioners wished to take advantage of the Section 992(c) deficiency distribution procedure, "International must both make a distribution and litigate its validity *before* our decision becomes final" (79 T.C. at 1059 (emphasis in original)). The court explained that, once its decisions become final, it lacks jurisdiction to alter or modify them (*ibid.*). "Thus," the court warned, "if International puts off making a deficiency distribution until after our decisions become final, this Court will be unable to recompute petitioners' deficiencies based on International's claim that it qualfied as a DISC by virtue of such deficiency distribution" (*ibid.*).

On the merits, the Tax Court agreed with the Commissioner that International's export commissions receivable were not "qualified export assets" inasmuch as Farms had failed to pay them within 60 days of the close of International's fiscal year, as the Regulations mandate (79 T.C. at 1064-1068, citing Treas. Reg. § 1.993-2(d)(2)). The court rejected petitioners' argument that the 60-day payment rule "adds to [the statute] a limitation which Congress did not require," holding that, to the contrary, the Regulation "harmonizes with the origin and purpose" of the DISC provisions (79 T.C. at 1064, 1065). Unless a DISC's parent were required promptly to pay accounts owed to the DISC, the Tax Court noted, the DISC in effect could lend money to its parent for indefinite periods of time in that way, and thus circumvent the rigorous limitations that Congress placed on producer's loans (79 T.C. at 1065-1066).

The Tax Court filed its supplemental opinion on December 23, 1982 (79 T.C. at 1054). There is no indication in the record that International made a Section 992(c) deficiency distribution to Farms between that date and October 3, 1983, the date on which the Tax Court entered its final decision in the case. That decision determined deficiencies in International's income taxes for 1975-1977 in the amounts of $173.91, $24,624.41 and $28,965.84 respectively—deficiencies based on the holding that International had failed to qualify as a DISC for those years. Compare 79 T.C. at 87 with Pet. App. A6 n.7. The Tax Court's decision thus reflects the fact that no deficiency distribution to enable International's retroactive qualification as a DISC was made.

4. The court of appeals unanimously affirmed (Pet. App. A1-A23). It agreed with the Tax Court that demand notes cannot be producer's loans under the "plain meaning of [Section] 993(d)(1)" (Pet. App. A9). It rejected petitioners' argument that they had achieved "substantial compliance" with the statute by later substituting 5-year notes. "[T]he demand notes in question," the Eleventh Circuit held, "were neither in compliance nor in substantial compliance" with the statute (*id.* at A10-A11). The court of appeals also agreed with the Tax Court's supplemental opinion concerning International's export commissions receivable, holding that the Regulations' 60-day payment rule was valid and rejecting petitioners' contention that the Commissioner had abused his discretion in giving the Regulations retroactive effect (*id.* at A11-A23).

ARGUMENT

1. Petitioners reiterate somewhat half-heartedly their contention (Pet. 2, 17-18) that International's demand notes qualified as "producer's loans." Petitioners do not contend that those notes met the specific requirements of the statute.

Rather, they argue that the loans complied with the spirit of the law because they were ultimately renewed within five years (*id.* at 17-18).

The courts below properly rejected petitioners' argument that strict compliance with the statute could be dispensed with. The imposition of stringent formal requirements—in the case of producer's loans, as in the case of the DISC provisions generally—was the method chosen by Congress to guarantee that those provisions' liberal tax benefits would not furnish an all-purpose tax shelter, but would be targeted exclusively to further the export of American goods. The requirement of a maturity date of five years or less was adopted for the purpose of monitoring the loan's duration and amount with a view to ensuring its export-relatedness. The legislative history emphasizes the importance of the requirement that "the loan must be evidenced by a note * * * and must have a stated maturity date of not more than 5 years." S. Rep. 92-437, *supra,* at 103; H.R. Rep. 92-533, 92d Cong., 1st Sess. 69-70 (1971). And the statute and legislative history make clear that the determination of whether an obligation constitutes a "producer's loan" is made "at the time of such loan" (I.R.C. § 993(d)(1)(D)), that is, on the date the loan is made. S. Rep. 92-437, *supra,* at 103-104; H.R. Rep. 92-533, *supra,* at 70-71; Treas. Reg. § 1.993-4(a)(2)(vi). Thus, the fact that petitioners replaced their nonqualifying demand notes with assertedly qualifying obligations five years later (Pet. 17-18) is legally irrelevant.

The Tax Court's holding on the producer's loan question, affirmed by the court of appeals, is plainly correct. Petitioners do not allege, nor is there, a conflict among the circuits on this question; indeed, the Eleventh Circuit's decision appears to be the first by a court of appeals on point. Because the holding that the demand notes are not "qualified export assets" is sufficient to support the Tax

Court's ultimate determination that International did not qualify as a DISC during 1975-1977, and thus to support the Tax Court's decision determining deficiencies in petitioners' tax for those years, this case warrants no further review.

2. Petitioners devote the bulk of their petition (Pet. 2, 9-16) to a request that the Court consider the validity of the Treasury Regulations, approved below, which impose a 60-day payment requirement for export commissions receivable. This question is not properly presented here, and does not warrant certiorari in any event.

As noted above (at 5), the Tax Court addressed the "qualified export asset" status of International's export commissions receivable in response to petitioners' motion for reconsideration. Although such motions are "generally denied in the absence of substantial error or unusual circumstances" (79 T.C. at 1057), the court exercised its discretion in petitioners' favor upon their representation that they intended to have International make a distribution of nonqualifying assets under Section 992(c). See 79 T.C. at 1057, 1059. The court in its supplemental opinion specifically warned petitioners that, given its limited jurisdiction to enter "[a] decision * * * specifying the amount of the deficiency" (I.R.C. § 7459(c)), International would have to make its distribution "*before* our decision becomes final" (79 T.C. at 1059 (emphasis in original)). The Tax Court waited more than nine months before entering its final decision, allowing petitioners ample time to comply with that admonition, but no distribution, as far as the record shows, was ever made. The Tax Court's decision, moreover, plainly indicates that no distribution was ever made, or at least that none was brought to the court's attention. The purpose of such a distribution would have been to enable International to qualify as a DISC for 1975-1977, but the deficiencies determined by the Tax Court reflect its holding

that International did *not* qualify as a DISC for those years. Compare 79 T.C. at 87 with Pet. App. A6 n.7. Having failed to take the step that furnished the predicate for the Tax Court's grant of their motion for reconsideration, and having thus caused the Tax Court in effect to render a purely advisory supplemental opinion, petitioners cannot be heard to attack the Tax Court's disposition here.

Even if the "commissions receivable" question were properly presented, moreover, it would not merit review because its resolution would not affect the outcome of this case. As noted above (at 6), the determination that the demand notes were not "producer's loans" independently precluded International's qualification as a DISC for 1975-1977, and thus provided a fully adequate basis for the court of appeals' affirmance of the Tax Court's decision. See Pet. App. A10-A11. Even if petitioners were to prevail on the question they seek to present, therefore, it would have no effect on their tax liabilities for the years at issue.

In any event, the "commissions receivable" question does not warrant certiorari. As the courts below correctly held (Pet. App. A18-A19; 79 T.C. at 1065-1066), the 60-day payment rule incorporated in the challenged Regulations is consistent with and in furtherance of Congress's objectives, for it prevents DISCs from circumventing the carefully-structured statutory restrictions on producer's loans by the simple expedient of letting "commissions receivable" remain unpaid indefinitely. Although petitioners, noting that the Claims Court in 1984 had invalidated the Regulations at issue (*Thomas International Ltd.* v. *United States*, 6 Cl. Ct. 414 (1984)), sought to posit "a potential conflict developing between the Eleventh Circuit and the Federal Circuit" (Pet. 11), that conflict never materialized, for the Claims Court's decision was recently reversed, and the validity of the Regulations sustained, by the Federal Circuit. *United States* v. *Thomas International Ltd.*, No.

85-870 (Fed. Cir. Sept. 18, 1985). As a result, the Regulations have now been upheld by every court of appeals to consider the question. Accord, *Lecroy Research Systems Corp.* v. *Commissioner,* 751 F.2d 123, 125-126 (2d Cir. 1984).

Although the courts of appeals have unanimously upheld the Regulations' validity, they have disagreed, as petitioners observe (Pet. 9-11), about whether the Regulations should be given retroactive effect. Compare Pet. App. A19-A23 (sustaining retroactive application) with *Lecroy Research Systems Corp.* v. *Commissioner,* 751 F.2d at 126-128 (rejecting retroactive application). Because the Regulations were promulgated in final form in 1977, however, the narrow question of their retroactive application can arise only for tax years ending in 1976 or before, and thus has little if any remaining importance. Moreover, as petitioners note (Pet. 17), the DISC provisions as a whole have been superseded for tax years after 1984. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, *§* 801, 98 Stat. 985, (enacting I.R.C. *§§* 921-927) (replacing DISC system with system of foreign sales corporations (FSCs)).

In sustaining the Regulations' retroactive application, finally, the court of appeals' decision is correct. Under Section 7805(b), Treasury Regulations are presumptively retroactive in their effect, and the Commissioner's decision to grant exceptions from that rule is reviewable only for abuse of discretion (Pet. App. A20). There was no unfairness in the retroactive application of the instant Regulations to petitioners, since the 60-day payment rule to which they object was incorporated in proposed regulations published in the Federal Register in 1972 (37 Fed. Reg. 19625,

20853), several years before the 1975-1977 tax years at issue here.[2]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FRIED
Acting Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

ERNEST J. BROWN
DAVID ENGLISH CARMACK
Attorneys

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[2]In arguing against retroactive application, petitioners assert (Pet. 9-11) that they relied to their detriment on a Treasury publication, *DISC—A Handbook for Exporters*, 1972-1 C.B. 679, 682, which provided a "plain language" outline of the DISC provisions without mentioning any 60-day payment requirement. As the courts below noted, however, the *Handbook* did not deal with export commissions receivable. See Pet. App. A19; 79 T.C. at 1067. In any event, the 60-day payment rule was clearly set forth in proposed regulations later in 1972.